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IN THE

Supreme Court of the United States

October Term, 1948

No. ~~823~~. 86

BATTEN, BARTON, DURSTINE & OSBORN, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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Eugene T. McQuade,
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Pandick Press, Inc., 22 Thames St., New York 6, N. Y., U. S. A.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. .

BATTEN, BARTON, DURSTINE & OSBORN, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner prays that a Writ of Certiorari be issued to review a judgment of the Court of Appeals for the Second Circuit (R. 29) reversing a decision of the Tax Court of the United States (R. 14) in favor of the petitioner that there was no deficiency in income tax or in declared value excess profits tax for the calendar year 1939, and that there was a deficiency in income tax for the calendar year 1941 in the amount of $2,523.14.

Opinions Below.

The opinion of the Court of Appeals is reported in 171 F. 2d 474 and is printed at R. 23. The opinion of the Tax Court is reported at 9 T. C. 448, and is printed at R. 3.

Jurisdiction of this Court.

The judgment of the Court of Appeals was entered on December 23, 1948. A petition for re-hearing filed by petitioner on January 5, 1949 was denied by the Court of Appeals on January 20, 1949 (R. 35). The time within which to file this petition was extended to and including June 18, 1949 by order dated April 11, 1949 (R. 37). The jurisdiction of this Court is invoked under Sections 1254 and 2101 of the Judicial Code (28 U. S. C.)

Questions Presented.

1. Does a taxable gain or deductible loss result from the taxpayer's sales of treasury stock at current book value, where, upon taxpayer's organization, the stock had been donated to the taxpayer by its stockholders ratably in accordance with their respective holdings?

2. Does a taxable gain or deductible loss result from the taxpayer's sale of treasury stock at current book value, where the stock had been previously purchased by the taxpayer at current book value?

Statement of Facts.

The pertinent facts are not in dispute and as found by the Tax Court (R. 4) and disclosed by the exhibits, may be summarized as follows:

The petitioner is a New York corporation, organized in 1928 with an authorized capital stock of 50,000 shares without par value and all of one class. All 50,000 shares of the authorized capital stock was issued upon the organization of the corporation in 1928. Simultaneously each stock-

holder donated to the petitioner's treasury 20 per cent of the shares initially issued to him, 10,000 shares being thus donated.

Petitioner's business is that of an advertising agency and its staff, apart from the usual clerical and similar employees, consists largely of skilled, creative writers, artists and radio directors upon whose work the success of the business depends.

Shares of stock were allotted and sold to employees from time to time upon the recommendation of the department heads and approval by the petitioner's Executive Committee.

Petitioner acquired stock from time to time from various stockholders who had resigned or were discharged or from their estates, in case of death, in liquidation of their interest in accordance with the Stockholders' Agreement of March 3, 1933.

All purchases and sales of stock by the petitioner were made at book value. There was no negotiation as to price and the petitioner did not attempt to choose a time favorable to it for the purchase or sale of stock. All of the petitioner's outstanding stock is owned by the employees and all shares are held subject to the Stockholders' Agreement to which petitioner and all its stockholders are parties. At the end of 1939, seventy-eight (78) employees were stockholders and at the end of 1941 one hundred ten (110) employees were stockholders. These shares were widely distributed among the employees. Out of 29,426 shares outstanding at the end of 1941, the largest individual holding was 2,518 (Exhibit 4-D, R. 17). The shares were not listed on any Stock Exchange and there is no "over-the-counter" market for the stock.

The petitioner did not at any time carry treasury stock as an asset on its books or on its balance sheet, nor was treasury stock voted or dividends paid on it. No changes were made in petitioner's capital structure by reason of the purchase and sale of treasury stock.

During 1939 the petitioner sold to officers and employees at an average price of $55.93 per share, 11,591 shares, of which 5,583 were part of the original donated shares. There were two principal reasons for the large sales in 1939: First, the institution of a plan whereby additional shares were allotted to employees, and Second, the taxpayer was in need of additional working capital.

During 1941 petitioner sold 7,877 shares to employees at an average price of $66.74 per share, all of which had been purchased previously from stockholders at various times.

The Commissioner, in his deficiency notice for the two taxable years, included in petitioner's gross income for 1939 the amount of $88,925.99 representing the gain on the sale of both donated and repurchased stock in that year; for 1941 the amount of $4,769.15 was included in gross income, as the gain on the sale of treasury stock in that year.

The Tax Court, on these facts, held that the above amounts should not have been included in petitioner's gross income in the two taxable years.

Reasons for Granting the Writ.

I. Under the decision of the Court below, three important questions of Federal law arise which have not been but should be settled by this Court.

(1) Has the Court of Appeals power to reverse the findings of the Tax Court? The Court of Appeals sustained the Commissioner's contention that an issue of law was involved in determining whether the taxpayer dealt in its own shares as it might in the shares of another corporation within the meaning of Reg. 103, Sec. 19.22(a)-16. The taxpayer contends the issue was one of fact. If it was one of fact, the Court of Appeals had no power to reverse unless the finding was clearly erroneous.

Is the issue one of fact or law?

This court has established no clear test to apply in determining whether a question is one of law or fact. The many apparently irreconcilable decisions under the Dobson Rule (which has been legislatively repealed) leave open this fundamental question. It is one of great importance in the administration of the revenue acts; it fixes the limits of the reviewing powers of the Courts of Appeal; it is one on which this court should speak definitely. The cases on the point are discussed in the appended brief wherein the taxpayer suggests the adoption of the test laid down by the House of Lords: a question of fact is a question of degree, *i. e.*, how one estimates the various elements of fact combining to make up the ultimate fact; a test which this court has impliedly used in the cases cited, including, for example, the holding in *Commissioner* v. *Scottish American Investment Co., Ltd.*, 323 U. S. 119, that a question of fact was involved in determining whether a taxpayer had an office

or place of business in the United States, within the meaning of Sec. 231(b) of the Revenue Acts of 1936 and 1938.

(2) Are the receipts from the sale of *donated* treasury shares "income" within the meaning of the Sixteenth Amendment and of I. R. C. Sec. 22(a)? The corporation's receipts from the sale at book value of shares of its own capital stock which had been previously ratably donated to it by its stockholders constitute capital. Such receipts are not income within the meaning of the Sixteenth Amendment. A tax on such receipts is a direct, unapportioned tax on property, and, as such, violates Article I, Sec. 2, Cl. 3 and Article I, Sec. 9, Cl. 4 of the Constitution.

The Court of Appeals was in error in holding that the sales of donated shares gave rise to taxable gain or deductible loss.

It is a common corporate practice for stockholders to make ratable donations of shares to a corporation's treasury, a practice that enables new ventures to give stock "bonuses" in connection with the sale of other securities. This widely-used method of corporate financing must be discontinued if this court does not reverse the holding of the Court of Appeals in the case at bar, for its effect is to subject to capital gains taxes the *entire* proceeds of the sale of donated shares.

(3) Does the sale, at book value, of treasury shares, previously purchased at book value, give rise to taxable gain or deductible loss?

The method of operation of 87 open-end investment trusts, with assets of about one and a half billion dollars, is affected by the decision in the case at bar and in *Aviation Capital, Inc.* v. *Pedrick* (C. C. A. 2nd), 148 F. 2d 165. Because of these decisions open-end investment trusts can-

not safely sell treasury shares even at book value, for such sales would result in capital gains under these decisions. Open-end investment trusts believe they avoid the problem by selling none but unissued shares.

In the case at bar the Court of Appeals' decision makes impracticable the continuance of the taxpayer's stock plan whereby the taxpayer has become a mutualized company, that is, its shares are entirely owned by employees and are distributed among 110 employees, no one of whom owns more than 6% of the outstanding shares. The decision of the court below interposes a grave obstacle to the general adoption of a desirable method of bringing about the participation of employees in the ownership of small enterprises; a method that brings them in at book value and assures them of book value upon their withdrawal from the business, thereby avoiding the hazard of speculative market fluctuations; a method that opens up a source of equity capital for small business in an era when equity capital is scarce.

II. The opinions in the Court of Appeals in this case, conflicting as they are, indicate the need of a ruling by this Court on the questions involved.

Three opinions were written in the Court of Appeals for the Second Circuit in this case (R. 23-28).

Judge Chase, relying upon his own opinions in *Aviation Capital, Inc.* v. *Pedrick* (C. C. A. 2nd) 148 F. 2d 165, and *Commissioner* v. *Air Reduction Co.*, (C. C. A. 2nd), 130 F. 2d 145, held that there were taxable gains. Judge Swan, recognizing the distinguishing facts of this case, upheld the Tax Court's determination that there had been no taxable gain. Judge Frank's concurring opinion, which resulted in the reversal of the Tax Court's decision, states that to

consider "treasury stock as a capital asset is irrational" and cites his own concurring opinion in the *Aviation Capital* case (*supra*) and the opinions of Judge Learned Hand in *E. R. Squibb & Sons* v. *Helvering*, (C. C. A. 2nd) 98 F. 2d 69, and in the *Air Reduction* case (*supra*) to support his statement. Solely on the ground that this "irrational" doctrine had been adopted in the Second Circuit in the above cases, Judge Frank felt that the "untenable premise" must be "carried out logically."

It is submitted that this Court should review a judgment resting on a foundation so illogical and erroneous.

Prayer.

For the foregoing reasons, which are developed in more detail in the accompanying brief, your petitioner prays that a Writ of Certiorari issue out of this Court to the United States Court of Appeals for the Second Circuit.

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BRIEF IN SUPPORT OF PETITION.

Opinions Below.

The opinion of the Court of Appeals is reported in 171 F. 2d 474 and appears at R. 23. The opinion of the Tax Court is reported at 9 T. C. 448 and appears at R. 3.

Jurisdiction of this Court.

This is set forth at p. 2 in the preceding petition under the heading "Jurisdiction of this Court."

Statement of the Case.

This is stated in the petition at pp. 2-4 under the heading "Statement of Facts".

Specification of Errors.

The Court is respectfully referred to that part of the petition which sets forth the questions presented (p. 2) and the reasons for the allowance of the Writ (pp. 5-8).

Summary of the Argument.

1. The Court of Appeals for the Second Circuit exceeds its powers in reversing the decision of the Tax Court. The Tax Court decided a question of fact which, not being clearly erroneous, was binding on the Court of Appeals.

2. The ratable donation of shares by the stockholders and their subsequent sale at book value were capital transactions. The receipts from such sales are not taxable as

income under the Sixteenth Amendment to the Constitution. To so tax such receipts would be in violation of the constitutional provisions requiring direct taxes to be apportioned according to the population.

3. The purchase and sale of treasury shares at book value do not give rise to taxable gains or deductible losses. Such transactions in a mutualized company are no more than capital readjustments. When the taxpayer purchases shares from a withdrawing stockholder the equity of the remaining stockholders remains unchanged, the withdrawing stockholder receiving only his proportionate part of the net assets of the company. When the taxpayer sells shares to a new stockholder at book value the new stockholder merely matches the existing investment of the other stockholders. These transactions do not give rise to income within the meaning of the Sixteenth Amendment.

4. The irreconcilable conflicts in the three opinions of the Court of Appeals in the case at bar require clarification by this Court in order to settle questions of wide public interest.

ARGUMENT.

POINT I.

The Court of Appeals lacked jurisdiction to set aside the decision of the Tax Court on a Question of Fact, not clearly erroneous.

The issue presented to the Tax Court in this case was factual. All that the Tax Court decided, in fact all that it was required to decide under the regulation, was that the facts and circumstances surrounding the taxpayer's treas-

ury stock transactions did not constitute dealing in its own shares as it might in the shares of another corporation. The Tax Court (R. 13), per Judge Black, restates the pertinent facts of this case and concludes "for these and other reasons we did not think petitioner was dealing in its own shares as it might in the shares of another corporation."

The circumstance that the facts of this case are all stipulated or undisputed does not make the issue any less factual. In *Boehm* v. *Commissioner*, 326 U. S. 287, 293 (1943), this Court said:

> "The circumstance that the facts in a particular case may be stipulated or undisputed does not make this issue any less factual in nature."

The Commissioner contended below that a question of law was involved in applying the provisions of the Internal Revenue Code to the undisputed facts in the case at bar. The Court of Appeals was in error in agreeing with the Commissioner. Whether an issue raises a question of law or fact is one of great importance in the administration and enforcement of the revenue acts and should be reviewed by this Court. Until this question is decided, the scope of the jurisdiction of the Courts of Appeal to review decisions of the Tax Court will be unsettled. The issue in the case at bar will give this Court an opportunity to state the law.

The many apparently irreconcilable decisions under the now-repealed Dobson Rule still leave open the fundamental issue: When is a question one of law and when one of fact? It may be of some persuasive value that the House of Lords has laid down a workable test.

The English courts hold that the hall-mark of a "question of fact" is that it is a "question of degree", i.e., how one estimates and appreciates the various elements of fact combining to make up the ultimate fact. In *Currie* v. *Inland*

Revenue Commissioners, 2 K. B. 332 (1921) this identity of "questions of degree" and of "fact" was first emphasized. There the Commissioners had found that the appellant was not "carrying on a profession *within the meaning of* Section 39(c), Finance (No. 2) Act of 1915; their finding was held to be an unreviewable "conclusion of fact" since it was a "question of degree" whether the activities could be summed up to be of a professional or of a business nature. The decision of the House of Lords in *Inland Revenue Commissioners* v. *Lysaght,* A. C. 234 (1928) determined once and for all, that if the issue before the Courts could be described as a "question of degree" it followed that the Commissioners' conclusion must be one of fact. Because the *Lysaght* case is so close to the case at bar it is desirable to consider the judgments in that case.

In *Lysaght's* case the Commissioners, after setting out the facts admitted or proved in evidence, held that the taxpayer was both ordinarily resident and resident in England. The sole issue before the courts was whether this determination was a 'conclusion of fact' or whether the meaning of the term 'resident' in the Income Tax Act was a 'question of law'. The Court of Appeal took the latter view.

The judgments in the House of Lords turned solely on this issue of 'fact' or 'law' and whether the interpretation of the term 'resident' was a matter for the Commissioners or for the Court.

The view of the majority of the Law Lords was, perhaps, best epitomized by Lord Buckmaster, at page 247:

> "According to the respondent whether a man is resident * * * here must always be a question of law dependent upon the legal construction to be placed upon the provisions of an Act of Parliament. I find myself unable to accept this view. It may be true

> that the word 'reside' * * * in other Acts may have special meanings, but in the Income Tax Acts it is used in its common sense and *it is essentially a question of fact whether a man does or does not comply with its meaning* * * * the matter must be a matter of *degree* and the determination whether or not the degree extends so far as to make a man * * * resident here is for the Commissioners, and it is not for the Courts to say whether they would have reached the same conclusion."

In the case at bar, the Tax Court held, in the *very* words of the Regulations that the taxpayer was not dealing in its own shares "as it might in the shares of another corporation." (R. 14). That this was a finding of ultimate fact is suggested by the following holdings:

In *Commissioner* v. *Scottish American Investment Co., Ltd.*, 323 U. S. 119, this Court held that a finding by the Tax Court that the respondents had 'an office or place of business' in the United States, within the meaning of Sec. 231(b) of the Revenue Acts of 1936 and 1938, was a 'conclusion of fact' which was not reviewable as there was substantial evidence to justify it, although contrary inferences might equally well have been drawn.

In *Trustees of Bingham* v. *Commissioner,* 325 U. S. 365, this Court held that the Tax Court's finding, that certain disbursements were 'expenses of management' of trust property, within the meaning of Sec. 23(a)(2) of the Internal Revenue Code, was one of fact.

In *Commissioner* v. *Tower,* 327 U. S. 280, this court held that the finding of the Tax Court, that there was not a partnership between husband and wife, was a question of fact.

In *Odhams Press, Ltd.* v. *Cook,* 56 T. L. R. 704 (H. L.) (1940) without discussion, the House of Lords held that a

finding by the Commissioners of Inland Revenue in the *very* words of the Income Tax Law was one of fact.

It is submitted that the fundamental issues in the case at bar were questions of fact.

Under the recent amendment to Sec. 1141(a) of the Internal Revenue Code, the Court of Appeals was given the jurisdiction to review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Courts in civil actions, tried without a jury". Rule 52 of the Federal Rules of Civil Procedure provides that in all actions tried upon the facts without a jury, findings of fact shall not be set aside unless "clearly erroneous".

In order to set aside the Findings of Fact by the Tax Court, the Court of Appeals must hold that the finding was clearly erroneous. (Rule 52, Federal Rules of Civil Procedure, Sec. 1141(a) of the Internal Revenue Code). No such holding is to be found in the decision of the Court of Appeals in this case. This being so, the taxpayer contends that the Court of Appeals lacked jurisdiction to set aside the Finding of Fact.

POINT II.

The sales of donated shares were capital transactions and hence not taxable under the Sixteenth Amendment or I. R. C. Sec. 22(a).

The receipts of the taxpayer from the sale by it at book value of shares of its own capital stock ratably donated to it by its stockholders is capital and hence not taxable under the Sixteenth Amendment of the Constitution or Sec. 22(a) of the Internal Revenue Code.

It its opinion, the Court of Appeals states that the decisions have made clear that Sec. 22(a) was intended

to include in gross income everything which in fact is "income derived from any source whatever." However, Sec. 22(a) does not include in gross income receipts which in fact are not income at all.

The prior regulations (Reg. 77, Art. 66), from 1924 to 1934, mirrored this principle by stating that no taxable gain resulted from sales of donated shares:

> "If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the shareholders donate or return to the corporation to be resold by it certain shares of stock of the corporation, previously issued to them * * *, the sale of such stock will be considered as a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income to the corporation."

The removal of these provisions from the regulation did not make any less true the fundamental principles contained therein.

The ratable donation of shares by the stockholders to a corporation is but the reverse of a stock dividend and should be given the same tax treatment as a stock dividend.

This Court has held in *Eisner* v. *Macomber,* 252 U. S. 189 (1920) and in *Towne* v. *Eisner,* 245 U. S. 418 (1918), that stock dividends were not intended by Congress to be taxed as income and that to do so would be in violation of the constitutional provisions[1] requiring direct taxes to be apportioned according to the population. *Helvering* v. *Griffiths,* 318 U. S. 371 (1943).

The courts have consistently held that when a stockholder donates shares to the corporation, he does not correspondingly reduce the cost basis of his remaining shares, but retains as the cost basis for his remaining shares that

[1] Art. I, Sec. 2, Cl. 3, and Art. I, Sec. 9, Cl. 4.

which he had for all the shares prior to the donation. See *Kistler* v. *Burnet*, (App. D. C.) 58 F. 2d 687; *Taylor* v. *McLaughlin*, 30 F. Supp. 19, (E. D. Pa.); *Murphy* v. *Commissioner*, decided July 28, 1945 (T. C. Memo Dec., 1945 P-H, par. 45,269); *Scoville* v. *Commissioner*, 18 B. T. A. 261; *Bed Rock Petroleum Co.* v. *Commissioner*, 29 B. T. A. 118. It would seem to follow that in the hands of the corporation the cost basis of the donated shares is zero, a feature that is distinctively characteristic of unissued shares. If sales of ratably donated shares give rise to taxable gain, then the entire sales price received by the corporation would be clearly taxable gain.

Even though this result was avoided in the case at bar by a fortuitous stipulation as to cost basis, it does throw light on the real nature of donated shares and indicates that, under the Internal Revenue Code, they should be considered the same as unissued shares, that is, as capital transactions giving rise to no taxable gain or deductible loss.

This court should review the question because of its impact upon the widely used method of corporate financing whereby donated shares are given as a "bonus" in connection with the sale of other corporate securities. The effect of the decision below is to subject to capital gains taxes the *entire* proceeds of the sale of donated shares. The incidence of tax would make the cost of such sales prohibitive.

POINT III.

The sales at net asset value of shares purchased at net asset value gave rise to no capital gain.

The capital nature of these transactions is determinatively characterized by the fact that every purchase and every sale was made at book value. The absurdity of con-

sidering part of the selling price of stock as gain under such circumstances has been clearly pointed out by Judge Learned Hand in his opinion in *E. R. Squibb & Sons* v. *Helvering*, (CCA 2nd), 98 F. 2d 69, and in his dissenting opinion in *Commissioner* v. *Air Reduction Co.*, (C. C. A. 2nd), 130 F. 2d 145. In the *Squibb* case, Judge Hand said, at pp. 70-71:

> "* * * Nevertheless it is very difficult—indeed to to us it seems impossible—to understand how the notion of a gain to the corporation from such transactions is legally tenable, except when the sale of the shares is at a price higher than their real value at the time of the sale. Such a belief must depend upon the mistaken supposition that after purchase the shares have an existence as such, and are more than a mere power to issue shares, like authorized, but unissued, shares. This seems to us unsound. Borg *v.* International Silver Company, 2nd Cir., 11 F. 2d 147.
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> "If one regards the corporation as the group of its shareholders collectively, that is very apparent. If they sell 'treasury shares', bought at a lower price, what really happens is that the group has been enlarged; new shareholders have been added. Always assuming that the shares are sold at their true value, the old group has not profited because the sale of the 'treasury shares' leaves the value of their own shares absolutely untouched. The purchase price received for each 'treasury share' sold will by hypothesis exactly match the value of each old share, and the sold share will neither trench upon, nor leave any margin of profit for, the old shares. All that has happened is that a larger group is doing business with a proportionally increased capital. The same is true also, if the corporation is regarded as a juristic person, stricti juris. Before the sale of 'treasury shares', the corporation is liable to its shareholders

> in the sum of their claims against it, which equal the net value of its then assets, including any increase in their value during the period when the 'treasury shares' have been held. The corporate assets are of course increased by the sale, but the new shares create new liabilities which will precisely equal the increase and there can be no profit to the corporation."

From a realistic point of view, the taxpayer's purchases and sales of its shares at book value are no more than capital readjustments, additions being made when new employees are made stockholders and deductions being made when employees withdraw from the company. Neither the taxpayer nor its stockholders are one cent richer after a purchase or sale has been made: a new stockholder matches, per share, the equity of the others; a withdrawing stockholder takes out his proportionate share of the taxpayer's net worth.

From 1918 to 1932 the regulations of the Treasury relative to such transactions (Reg. 45, Art. 542), provided that a "corporation realizes no gain or loss from the purchase or sale of its own stock." But in 1934 the Treasury changed its regulation to its present form (Reg. 111, Sec. 29.22(a)-15) providing that the taxability of gain realized on the sale by a corporation of its own capital stock "depends on the real nature of the transaction which is to be ascertained from all the facts and circumstances", and that a taxable gain or deductible loss results "if a corporation deals in its own shares as it might in the shares of another corporation."

A realistic application of I. R. C. Sec. 22(a) should free from tax the sale of treasury shares at book value previously *purchased* at book value.

In the case at bar the real nature of the transactions are such as to give rise to no tax consequences. It is submitted that if this case does not present a factual situation intended to be considered non-taxable under the Treasury's regulation, then no such situation exists and the regulation, instead of being a guide to taxpayers has been used to mislead.

The consequences of the decision below is of serious concern to every "open-end" investment management company, in which companies the public has invested over one and a half billion dollars.[2] Such companies are defined by statute (15 U. S. C. 80a-5) as investment management companies offering for sale or having outstanding redeemable securities of which they are the issuer. The corporate charters of these corporations uniformly provide that purchases and sales of their capital stock are to be made at "liquidation" or "net asset" value plus a small expense charge. Because of the lower court decision in this case and the case of *Aviation Capital, Inc., supra,* which preceded it, "open-end" investment management companies, in order to avoid an unwarranted tax burden, have been forced to suspend or to discontinue altogether the issuance of shares which have been repurchased as required by law.

A reading of the prospecti of numerous "open-end" investment management companies on file with the Securities Exchange Commission, discloses the following comments relative to sales of treasury shares:

> "The security to be offered hereunder is the unissued capital stock of Incorporated Investors. The

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[2] "From the end of 1945 to the end of 1948, the total assets of 87 big open-end investment trusts increased more than \$550 million to about \$1.5 billion—a rise of more than 50% * * *. Growth in the size of the investment trusts' stockholder lists has been just as spectacular. Back in 1940, there were about 750,000 shareholders; today there are more than 1.1 million." Business Week, March 26, 1949, page 93.

company also proposes to sell shares heretofore registered and now held in the treasury if and when the resale thereof will not involve risk of being chargeable with taxable profit on such resale, which risk exists under present Federal tax rulings." (Incorporated Investors—Prospectus 5/25/48).

"The fund proposes to sell, from time to time, its unissued shares and the shares in its treasury. Under present conditions and tax rulings, shares in the treasury cannot be sold without risk of incurring taxes on "gains" realized by such sales, so that no such sales are presently contemplated. (Loomis Sayles Mutual Fund, Inc.—Prospectus 8/31/48)."

Notwithstanding the importance of the question involved, this Court has never passed upon this regulation as an interpretation of Sec. 22(a). This Court has many times granted certiorari in cases involving the interpretation of the general provisions of Sec. 22(a), particularly where, as in this case, the question involved is of importance to the public.[3] It is submitted that a ruling on this regulation is imperative at this time.

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[3] *Commissioner* v. *Jacobson*, 336 U. S. 28 (1949); *Bazley* v. *Commissioner*, 331 U. S. 737 (1947); *Helvering* v. *Griffiths*, 318 U. S. 371 (1943); *Helvering* v. *Horst*, 311 U. S. 112 (1940); *Helvering* v. *Clifford*, 309 U. S. 331 (1941); *M. E. Blatt Company* v. *United States*, 305 U. S. 267 (1938).

POINT IV.

The Three Opinions of the Court of Appeals in this case disclose conflicts which should be settled by this Court.

Judge Chase's opinion in the Court of Appeals relies largely upon *Aviation Capital, Inc.* v. *Pedrick, supra,* and *Commissioner* v. *Air Reduction Co., supra,* two cases in which he, himself, wrote the majority opinions. This opinion would seem to indicate that Judge Chase shares the Commissioner's present interpretation that all treasury stock transactions are taxable. Neither of the two judges sitting with Judge Chase on this case shared this opinion, but the decision of the Tax Court was, nevertheless, reversed. Judge Swan, in dissenting, held that the facts distinguished the case from other cases in the Second Circuit and said (R. 28):

> "There are numerous unusual circumstances in the present case which differentiate it, in my opinion, from decisions which have held taxable gain from the purchase and sale of 'treasury stock.' For the reasons stated by the Tax Court, 9 T. C. 448, I think that the taxpayer did not deal in its own shares 'as it might in the shares of another corporation', consequently I would affirm the decision."

Judge Frank, reluctantly concurring with Judge Chase, said (R. 28):

> "As I said in concurring in Aviation Capital *v.* Pedrick, 148 F. 2d 165, 168 (C.C.A.-2), I think it irrational ever to consider 'treasury stock' as a capital asset in these cases. See L. Hand, J., in E. R. Squibb & Sons *v.* Helvering, 98 F. 2d 69 (C.C.A.-2) and his dissenting opinion in Commissioner *v.* Air

> Reduction Co., 130 F. 2d 146 (C.C.A.-2). But that doctrine is now accepted in this circuit. The situation, then, to my mind, is like that in a farce: An untenable premise, once adopted, is to be carried out logically. On that basis, a gift to a corporation of stock which becomes one of its capital assets is the same as a gift to it of any other property so that a profit on its sale by the corporation is a taxable gain."

It is submitted that the time has come to free the Court of Appeals for the Second Circuit from this "irrational" doctrine.

Conclusion.

The Court of Appeal's decision upholds an unconstitutional tax on capital and raises questions of continuing public importance in the administration of Federal tax law. A Writ of Certiorari to review it should be granted.

Respectfully submitted,

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Appendix.

Constitution:

Art. I, Sec. 2, Cl. 3:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, * * *"

Art. I, Sec. 9, Cl. 4:

"No Capitation, or other direct, tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

Sixteenth Amendment:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Section 22(a) of the Internal Revenue Code:

"(a) General Definition. 'Gross income' includes gains, profit and income derived from salaries, wages or compensation from personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *"

Section 1141(a) of the Internal Revenue Code:

"(a) Jurisdiction.—The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in Civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code."

Regulations 103, Sec. 19.22(a)-16 (Now Regulations 111, Sec. 29.22(a)-15):

"*Acquisition or disposition by a corporation of its own capital stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends on the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription price is in excess of, or less than the par or stated value of such stock.

"But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

Rule 52, Federal Rules of Civil Procedure:

"Findings by the Court.

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; * * * Findings of Fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. * * *"

INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1949

No. 86

Batten, Barton, Durstine & Osborn, Inc.
petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 3-14) is reported at 9 T. C. 448. The majority, concurring, and dissenting opinions of the Court of Appeals (R. 23-28) are reported at 171 F. 2d 474.

JURISDICTION

The judgment of the Court of Appeals was entered on December 23, 1948. (R. 29.) A petition for rehearing (R. 30-34) was denied January 20, 1949 (R. 35). By an order made by Mr. Justice Jackson on April 11, 1949, the time for filing a petition for a writ of certiorari was extended to and including June 18, 1949. (R. 37.) The petition for

a writ of certiorari was filed May 27, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Whether the taxpayer was taxable, under the provisions of Section 19.22(a)-16 of Treasury Regulations 103, upon the gain from sales of its "treasury stock", *i.e.,* sales of shares of its own stock which, after their original issuance, the taxpayer had reacquired and had held in its treasury until the resale thereof during the taxable years.

2. If so, then whether the taxpayer was taxable not only upon gain from the sale of treasury stock which it had reacquired by purchase, but also upon gain from the sale of treasury stock which had been donated to the taxpayer by its shareholders.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 12-13.

STATEMENT

The facts, as found by the Tax Court[1] (R. 4-9) and as recited in the majority opinion of the court

[1] Before the Tax Court, the facts in the case were developed by a stipulation between the parties, certain exhibits and oral testimony adduced in evidence, all of which were brought to the court below as part of the record on review. Only portions of that record were printed by the parties in the appendix to their respective briefs in the court below pursuant to the rules of that court, and those portions only have been included in the record filed by the taxpayer in this Court with its petition.

below (R. 23-28), may be summarized as follows:

The taxpayer is a New York corporation, organized in 1928 with an authorized capital stock of 50,000 shares of no par value and all of one class, all of which were issued upon its organization. Simultaneously, each stockholder donated to the taxpayer's treasury 20 percent of the shares initially issued to him, 10,000 shares being thus contributed to its treasury, so as to have stock available for issuance to other employees who demonstrated ability in order to insure their loyalty to the firm. The taxpayer's business is that of an advertising agency and its staff, apart from clerical and similar employees, consists largely of skilled creative writers, artists and radio directors, upon whose work the success of the business depends. (R. 4-5.)

From time to time shares of stock were sold to employees, upon recommendation of department heads and approval by the taxpayer's executive committee. Beginning in 1939, sales were made under an arrangement whereby the purchaser gave a note for the purchase price, leaving the stock with the taxpayer as security, and the interest on and principal of the note were to be paid by the application against them of dividends on the stock and by amounts deducted from the employees' bi-monthly salary checks. The purchaser had the right at any time within seven years to cancel his purchase, except as to shares already paid for, and in the event of the termination of his employment

for any reason other than death, the taxpayer had the right to repurchase any shares then unpaid for, at the original purchase price. (R. 5-6.)

The taxpayer also purchased shares from stockholders or their estates pursuant to an agreement between the stockholders and the taxpayer, under which a stockholder or his executors are required to offer his shares for sale to the taxpayer in the event of death, resignation, or discharge, the taxpayer being required to buy the shares of a deceased or discharged stockholder and having the option of buying the shares of a resigned stockholder, on terms and at a price [2] to be determined as prescribed by the agreement. A stockholder could sell shares only with the consent of the taxpayer, and was required first to offer them to the taxpayer. (R. 6-7.)

All purchases and sales of stock by the taxpayer were made at book value, without negotiation as to price or any attempt on the part of the taxpayer to choose a time favorable to it therefor. All of the taxpayer's outstanding stock is owned by employees, or their trustees, and is subject to the stockholders' agreement above mentioned. Seventy-eight employees were stockholders at the end of 1939, and 110 at the end of 1941. The shares were widely distributed among the employees. The

[2] Pursuant to the agreement, the price was to be the book value determined from the balance sheet as of the close of the preceding month.

stock was not listed on any exchange, and there is no "over the counter" market for the stock. (R. 7.)

Treasury stock was not carried as an asset by the taxpayer on its books or balance sheet, it was not voted, and no dividends were paid on it. No changes were made in the taxpayer's capital structure by reason of the purchase and sale of treasury stock. During the years 1928 to 1941, inclusive, the taxpayer acquired 55,957 shares of its stock which thereby became treasury stock, and sold 35,383 shares thereof (both figures including the 10,000 donated shares). (R. 7.)

During 1939, the taxpayer sold to officers and employees, at an average price of $55.93 per share, 11,591 shares of treasury stock, of which 5,583 were part of the donated shares. The large sales in 1939 were due, first, to the institution of a "stock plan", whereby additional shares were allotted and sold to employees, and, second, to the taxpayer's need of additional working capital. (R. 8.)

During 1941, the taxpayer sold, at an average price of $66.74 per share, 7,877 shares of treasury stock, all of which had been previously purchased from shareholders at various times. (R. 8.)

In his determination of deficiencies for the two taxable years, the Commissioner included in the taxpayer's income for 1939 and 1941, respectively, the amounts [3] of the taxpayer's gain on the sale of treasury stock in those years. (R. 8-9.)

[3] As pointed out in the opinion of the Tax Court (R. 10), there was no question as to the correctness of the *amounts*

The Tax Court upheld the taxpayer's first or main contention, to the effect that it was not taxable with any gain from the sales of treasury stock, and hence found it unnecessary to pass upon the taxpayer's alternative contention to the effect that, if taxable upon gains from the sale of treasury stock, it was taxable only upon the gain from shares reacquired by purchase and not upon gain from the sale of treasury stock which had been donated to it. (R. 9-14.)

The court below reversed, holding that the taxpayer was taxable upon the gain from its sales of treasury stock, including the gain upon the sale of donated shares. (R. 23-28.)

ARGUMENT

1. Upon the undisputed facts of this case, the court below correctly held that the taxpayer was taxable upon its gain from sales of "treasury stock" under the applicable provisions of the statute and Regulations, Section 22(a) of the Internal Revenue Code, and Section 19.22(a)-16 of Treasury Regulations 103, Appendix, *infra.*

Neither the Code nor the preceding Revenue Acts have specifically provided for the treatment

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of gain determined by the Commissioner for the two years, if such gain is properly taxable. In computing the gain from the sale of the donated shares, the Commissioner allowed the taxpayer a "cost" basis, which was arrived at by taking the cost to the "donors", as finally adjusted by agreement of record during the hearing before the Tax Court. See R. 27; see also taxpayer's brief, p. 16.

for income tax purposes of the gain or loss resulting from the sale of "treasury stock" by a corporation—*i.e.,* from the sale by a corporation of shares of its own stock which, after original issuance, it has reacquired and held in its treasury, without cancelling or retiring them. The Regulations, however, provide that the acquisition or disposition of its own stock by a corporation results in taxable gain or deductible loss depending "upon the real nature of the transaction", and that no gain or loss is to be recognized upon the original issuance of stock by a corporation but that gain or loss is recognized "if a corporation deals in its own shares as it might in the shares of another corporation". Section 19.22(a)-16, Treasury Regulations 103, Appendix, *infra.* The decision of the court below in this case is in keeping with all other court decisions which have considered the taxability of gain from sales of treasury stock under this provision of the Regulations, sustaining the taxing of such gain under a wide variety of circumstances. *Commissioner* v. *Rollins Burdick Hunter Co.* (C.A. 7th), decided May 19, 1949 (1949 P-H, ¶ 72,465);[4] *Commissioner* v. *Air Reduction Co.,* 130 F. 2d 145 (C.A. 2d), certiorari denied, 317 U. S. 681; *Aviation Capital* v. *Pedrick,* 148 F. 2d 165 (C.A. 2d), certiorari denied, 326 U. S. 723; *Helvering* v. *Edison Bros. Stores,* 133 F. 2d

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[4] This is a reversal of the Tax Court's decision in *Rollins Burdick Hunter Co.* v. *Commissioner,* 9 T. C. 169, relied upon by the Tax Court in its opinion in this case. (R. 12-13, 14.)

575 (C.A. 8th), certiorari denied, 319 U. S. 752; *Brown Shoe Co.* v. *Commissioner,* 133 F. 2d 582 (C.A. 8th); *United States* v. *Stern Bros. & Co.,* 136 F. 2d 488 (C.A. 8th); *Allen* v. *National Manufacture & Stores Corp.,* 125 F. 2d 239 (C.A. 5th), certiorari denied, 316 U. S. 679; *Dow Chemical Co.* v. *Kavanagh,* 139 F. 2d 42 (C.A. 6th); *Edwin L. Wiegand Co.* v. *United States,* 60 F. Supp. 464 (Ct. Cls.). See also *Investment Corp.* v. *United States,* 43 F. Supp. 464 (E.D. Pa.); *Trinity Corp.* v. *Commissioner,* 44 B.T.A. 1219, affirmed, 127 F. 2d 604 (C.A. 5th), certiorari denied, 317 U. S. 651.

The court below properly recognized (R. 26) that the absence of a profit motive and the presence of contract restrictions and obligations did not make the gains from sales of treasury stock non-taxable. See *Commissioner* v. *Rollins Burdick Hunter Co., supra; Allen* v. *National Manufacture & Stores Corp., supra; Dow Chemical Co.* v. *Kavanagh, supra; Aviation Capital* v. *Pedrick, supra.* Nor is such result required by the fact that the particular purposes motivating the taxpayer in these transactions in its own stock could not be accomplished by dealing in the stock of another corporation. *Commissioner* v. *Rollins Hunter Burdick Co., supra; Helvering* v. *Edison Bros. Stores, supra.* Equally irrelevant is the consideration that if the reacquired shares had been cancelled and retired and new shares had been subsequently issued, the tax liability might have been avoided, as the Tax Court indicated. (R. 11-12.) Tax liabilities

must be determined by what was actually done, not by what might have been done. See *Aviation Capital* v. *Pedrick, supra,* at p. 167; *Dow Chemical Co.* v. *Kavanagh, supra,* at p. 46. Contrary to the taxpayer's claim that its transactions in its own stock were merely capital readjustments (Br. 16, 18), there was no change in the taxpayer's capital structure by reason of its dealings in its own stock. (R. 7.) The transactions resulted merely in a change in the identity of the taxpayer's shareholders. See *Commissioner* v. *Rollins Burdick Hunter Co., supra.* And, contrary to the taxpayer's claim that it was not "one cent richer" (Br. 18) as the result of its transactions, it is clear that when a corporation reacquires some of its previously issued stock, retains it in its treasury, without retiring or cancelling it, and later resells it at a profit, without any change in its capital structure, it has derived gain or profit which is real and actual and which should be taken into account for tax purposes. To permit that profit to escape taxation would frustrate the well recognized purpose of Section 22(a) of the Code to tax income or profit from whatever source derived. The decision below is clearly correct and in keeping with decisions of other courts on this question, which this Court has repeatedly declined to review. Despite the presence of an occasional dissent in the cases cited above, there is no conflict among the Circuits. Problems arising with respect to so-called "open-end" investment management companies, upon

which the petitioner predicates its assertions as to the general importance of the present case (Pet. 6-7, Br. 19-20), obviously are not parallel to those here presented and would not be resolved by a review of this case.

2. The question presented to the court below was a pure question of law as to the proper interpretation or meaning of a provision of the Regulations, in the light of undisputed facts, which the court below correctly regarded as a reviewable question. See *Commissioner* v. *Rollins Burdick Hunter Co., supra; Dobson* v. *Commissioner,* 320 U. S. 489; *John Kelley Co.* v. *Commissioner,* 326 U. S. 521; *Trust of Bingham* v. *Commissioner,* 325 U. S. 365; *Crane* v. *Commissioner,* 331 U. S. 1; *McWilliams* v. *Commissioner,* 331 U. S. 694. Examination of the record and the decision below makes it plain that the Court of Appeals did not, as the petitioner claims (Pet. 5, Br. 14), reverse any finding of fact.

3. Having held, on the main question, that the taxpayer was taxable upon its gains from sales of treasury stock, the court below correctly also held that the gains taxable to the taxpayer included the gains from the sale of the shares which had been "donated" to the taxpayer. (R. 26-28.) There is clearly no reason for any different treatment of the "donated" shares. The taxpayer's gain from the sale of those shares was just as real as that from the sale of "repurchased" shares, and that gain should likewise be taxable just as the gain from the "repurchased" shares. No different result is

required for tax purposes by reason of any difference as to the manner in which shares have been reacquired, a matter which is immaterial, as long as their basis and the amount of the gain have been correctly computed, as they admittedly were in this case.

CONCLUSION

The decision below is correct. There is no conflict of decisions and the case presents no matter calling for review by this Court. The petition should therefore be denied.

Respectfully submitted,

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July, 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [As amended by Section 1 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
(26 U.S.C. 1946 ed., Sec. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.22(a)-16. *Acquisition or disposition by a corporation of its own capital stock.* Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription

or issue price be in excess of, or less than, the par or stated value of such stock.

But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code.

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